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American Institute of Certified Public Accountants. Auditing Standards Board

EXPOSURE DRAFT

PROPOSED STATEMENT ON AUDITING STANDARDS

THE AUDITOR'S RESPONSIBILITY TO DETECT AND REPORT ERRORS AND IRREGULARITIES

FEBRUARY 14, 1987

Prepared by the AICPA Auditing Standards Board
For comment from persons interested in auditing and reporting

Comments should be received by July 15, 1987, and addressed to
AICPA Auditing Standards Division, File 2545
1211 Avenue of the Americas, New York, N.Y. 10036-8775

SUMMARY

Why Issued

Some recent business failures have caused the public to question whether auditors—

- Have assumed sufficient responsibility to detect and report possible irregularities.
- Have been sufficiently effective in detecting material errors and irregularities.

The Auditing Standards Board is issuing this proposed statement on auditing standards to better serve the public interest by—

- Expanding the auditor's responsibility to detect and report irregularities and
- Improving the auditor's ability to detect material errors and irregularities (a) by discussing client characteristics that may increase the risk of material errors and irregularities and heighten professional skepticism concerning them and (b) by indicating how auditors might respond to those characteristics in planning and performing audit procedures and evaluating their results.

What It Does

This proposed Statement would supersede SAS No. 16, *The Independent Auditor's Responsibility for the Detection of Errors or Irregularities,* and requires auditors to—

- Design their audits to detect material errors and irregularities. But the proposed Statement recognizes that because of the characteristics of certain irregularities, an audit may not detect a material irregularity.
- Make a preliminary assessment of the risk of material irregularities and of the likelihood of management misrepresentation.
- Exercise due care and professional skepticism to achieve reasonable assurance that material errors and irregularities will be detected.
- Be assured that the audit committee, or others having equivalent authority and responsibility, is adequately informed about irregularities.
- Render an adverse opinion on the financial statements if they are materially affected by an irregularity and are not revised.
- Disclaim an opinion on the financial statements and communicate their findings in writing to the board of directors when the scope of the audit has been restricted with respect to a possible irregularity.

This proposed Statement also recognizes that the auditor may have a duty to disclose irregularities to parties outside the entity.

How It Differs From Existing Standards

This proposed Statement differs from SAS No. 16 in that it—

- Requires that an audit be designed to detect material errors and irregularities that affect the financial statements. SAS No. 16 indicates that the audit should be planned to search for material errors and irregularities.
- Addresses the detection of errors and irregularities in terms of audit risk.
- Provides more extensive guidance on professional skepticism.
- Requires the auditor to determine that the audit committee is informed about irregularities unless they are inconsequential. SAS No. 16 requires communication of possible material irregularities to—
  (1) A level of management at least one level above the employees involved, and
  (2) The board of directors or audit committee if the auditor's discussions with management indicate that possible irregularities may continue to exist.
- Requires an adverse opinion if financial statements are materially affected by an irregularity and are not revised.

This exposure draft has been sent to—

- *Practice offices of CPA firms.*
- *Members of AICPA Council and technical committees.*
- *State society and chapter presidents, directors, and committee chairmen.*
- *Organizations concerned with regulatory, supervisory, or other public disclosure of financial activities.*
- *Persons who have requested copies.*

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February 14, 1987

Accompanying this letter is an exposure draft of a proposed statement on auditing standards titled The Auditor's Responsibility to Detect and Report Errors and Irregularities. This Statement would supersede SAS No. 16, The Independent Auditor's Responsibility for the Detection of Errors or Irregularities.

Some recent business failures have caused the public to question whether auditors have assumed sufficient responsibility to detect and report errors and irregularities and whether auditors have been sufficiently effective in detecting and reporting them. The Auditing Standards Board is issuing this proposed Statement to better serve the public interest by expanding the auditor's responsibility to detect and report errors and irregularities and by improving the auditor's ability to detect them.

The Statement expands the auditor's responsibility to detect material errors and irregularities by requiring the auditor to design an audit to detect them. Existing standards contain a more limited responsibility to plan an audit to search for material errors and irregularities. The proposed Statement also recognizes that because of the characteristics of certain irregularities, a properly designed audit may not detect a material irregularity. These characteristics are discussed in the Appendix and include materiality, level of involvement, concealment, control structure, and financial statement effect.

The Statement expands the auditor's responsibility to report material irregularities by requiring the auditor to ensure that the audit committee, or others having equivalent authority and responsibility, is adequately informed of them. Existing standards contain a more limited responsibility to report material irregularities to a level of management at least one level above the employees involved and to the audit committee or board of directors only if the auditor's discussions with management indicate that possible irregularities may continue to exist.

This Statement also recognizes that in some circumstances the auditor may have a responsibility to report irregularities to parties outside the entity. These circumstances include the following: disclosure to the SEC in the event of a change in auditors; disclosure to a successor auditor in accordance with SAS No. 7, Communications Between Predecessor and Successor Auditors; disclosure to a court in response to a subpoena; and disclosure to specific agencies in accordance with governmental audit requirements.

This Statement improves the auditor's ability to detect errors and irregularities by identifying and discussing client characteristics that may increase the risk of material errors and irregularities and that may heighten professional skepticism concerning them. The Statement also provides guidance to the auditor about how to respond to those characteristics in planning and performing audit procedures and in evaluating their results.

This Statement also indicates that when the auditor concludes that the financial statements are materially affected by an irregularity, he should require that they be revised. If the statements are not revised, the auditor should express an adverse opinion on the statements taken as a whole. When the scope of the audit is restricted with respect to a possible irregularity, the Statement requires the auditor to disclaim an opinion on the financial statements and communicate his findings to the board of directors.

Comments or suggestions on any aspect of this exposure draft will be appreciated. The Auditing Standards Board's consideration of responses will be helped if the comments refer to specific paragraphs and include supporting reasons for each suggestion or comment.

In developing guidance, the Auditing Standards Board considers the relationship between the cost imposed and the benefits reasonably expected to be derived from audits. It also considers differences that the auditor may encounter in the audit of the financial statements of small businesses and, when appropriate, makes special provisions to meet those needs. Thus, the board would particularly appreciate comments on those matters.

Written comments on the exposure draft will become part of the public record of the Auditing Standards Division and will be available for public inspection at the offices of the AICPA after August 17, 1987, for one year. Responses should be sent to the AICPA Auditing Standards Division, File 2545, in time to be received by July 15, 1987. For convenience in responding, a perforated response form is attached and a postpaid return envelope is provided with this exposure draft.

Sincerely,

Jerry D. Sullivan

Jerry D. Sullivan
Chairman
Auditing Standards Board

Dan M. Guy

Dan M. Guy
Vice President, Auditing

PROPOSED STATEMENT ON AUDITING STANDARDS

THE AUDITOR'S RESPONSIBILITY TO DETECT AND REPORT ERRORS AND IRREGULARITIES

(Supersedes Statement on Auditing Standards No. 16, *The Independent Auditor's Responsibility for the Detection of Errors or Irregularities*)

1. This Statement establishes the independent auditor's responsibility for the detection of errors and irregularities in an examination of financial statements in accordance with generally accepted auditing standards.[1] It describes factors that influence the auditor's ability to detect errors and irregularities and explains how the exercise of due care should give appropriate consideration to the possibility of errors or irregularities. It also provides guidance on the auditor's responsibility to communicate detected matters both within and outside the entity whose financial statements are under examination.

DEFINITION OF ERRORS AND IRREGULARITIES

2. The term "errors" refers to *unintentional* misstatements or omissions in financial statements. Errors may involve—

- Mistakes in gathering or processing accounting data from which financial statements are prepared.
- Incorrect accounting estimates arising from oversight or misinterpretation of facts.
- Mistakes in the application of accounting principles relating to amount, classification, manner of presentation, or disclosure.[2]

3. The term "irregularities" refers to *intentional* misstatements or omissions in financial statements.[3] Irregularities include fraudulent financial reporting undertaken to render misleading financial statements, sometimes called management fraud, and misappropriation of assets, sometimes called employee fraud or defalcations. Fraud in this context is used as in common usage rather than in its strict legal sense. Irregularities may involve acts such as the following:

- Manipulation, falsification, or alteration of accounting records or supporting documents from which financial statements are prepared
- Misrepresentation or intentional omission of events, transactions, or other significant information
- Intentional misapplication of accounting principles relating to amounts, classification, manner of presentation, or disclosure

4. The primary factor that distinguishes errors from irregularities is whether the underlying cause of a misstatement in financial statements is intentional or unintentional. Intent, however, is often difficult to determine, particularly in matters involving accounting estimates or the application of accounting principles. For example, an unreasonable accounting estimate may result from unintentional bias or may be an intentional attempt to misstate the financial statements.

THE AUDITOR'S RESPONSIBILITY TO DETECT ERRORS AND IRREGULARITIES

5. An examination conducted in accordance with generally accepted auditing standards should be designed to detect material misstatements that affect the financial statements. As part of such an examination, the auditor assesses the risk that errors or irregularities have caused the financial statements to contain a material misstatement. Based on that assessment, which requires the auditor to understand the characteristics of errors and irregularities that are discussed in the Appendix and the complex interaction of those characteristics, the auditor designs and performs appropriate audit procedures and evaluates their results.

6. Because of the characteristics of certain irregularities, particularly those involving forgery and collusion, a properly designed and executed examination may not detect a material irregularity. For example, generally accepted auditing standards do not require that an auditor authenticate documents, nor is the auditor trained to do so. Also, audit procedures that are effective for detecting a misstatement that is unintentional may be ineffective for a misstatement that is intentional and is concealed through collusion between client personnel and third parties or among management or employees of the client.

7. The auditor should exercise due care in planning, performing, and evaluating the results of audit procedures, and the proper degree of professional skepticism to achieve reasonable assurance that material errors or irregularities will be detected. Since the auditor's opinion on the financial statements is based on the concept of reasonable assurance, the auditor is not an insurer and his report does not constitute a guarantee. Therefore, the subsequent discovery that a material misstatement exists in the financial statement does not, in and of itself, evidence

[1] Other editorial changes will be made to Statements on Auditing Standards (SASs) and SAS Interpretations (AICPA, *Professional Standards*, vol. 1) as appropriate to incorporate the wording of this pronouncement.

[2] Errors do not include the effect of accounting processes employed for convenience, such as maintaining accounting records on the cash basis or tax basis and periodically adjusting those records to prepare financial statements in conformity with generally accepted accounting principles.

[3] For purposes of this Statement, reference to material misstatements, whether caused by errors or irregularities, in subsequent paragraphs also includes a material omission.

inadequate planning, performance, or judgment on the part of the auditor.

Consideration of the Possibility of Material Misstatements in Audit Planning

8. In developing an audit plan, the auditor should specifically consider factors that influence audit risk that relates to several or all account balances and obtain an understanding of the control environment. These matters often have effects pervasive to the financial statements taken as a whole and also influence the auditor's consideration of risk at the account balance or class-of-transactions level.

9. *Considering Audit Risk at the Financial Statement Level.* A preliminary assessment of the risk of material irregularities should be made.[4] Factors such as those listed below may be considered. The auditor's understanding of the control environment may either heighten or mitigate the auditor's concern about the risk of material irregularities. The auditor should consider these factors in combination to make an overall judgment; the presence of some factors in isolation would not necessarily indicate increased risk.

- *Management Characteristics*
  - Management operating and financial decisions are dominated by a single person.
  - Management's attitude toward financial reporting is unduly aggressive.
  - Management (particularly senior accounting personnel) turnover is high.
  - Management places undue emphasis on meeting earnings projections.
  - Management's reputation in the business community is poor.
- *Operating and Industry Characteristics*
  - Profitability of entity relative to its industry is inadequate or inconsistent.
  - Sensitivity of operating results to economic factors (inflation, interest rates, unemployment, etc.) is high.
  - Rate of change in entity's industry is rapid.
  - Direction of change in entity's industry is declining with many business failures.
  - Organization is decentralized without adequate monitoring.
  - Solvency problems or other internal or external matters that bring into question the entity's ability to continue in existence are present. (See SAS No. 34, *The Auditor's Considerations When a Question Arises About an Entity's Continued Existence* [AICPA, *Professional Standards,* vol. 1, AU sec. 340].)
- *Engagement Characteristics*
  - Many contentious or difficult accounting issues are present.
  - Frequent and significant difficult-to-audit transactions or balances exist.
  - Nature, cause (if known), or the amount of known and likely misstatements detected in the examination of prior period's financial statements is significant.
  - New client with no prior audit history or sufficient information is not available from the predecessor auditor.

10. The size, complexity and ownership characteristics of the entity have a significant influence on the risk factors considered to be important. For example, for a large public company the auditor would ordinarily give more consideration to factors such as the effectiveness of the board of directors and audit committee in constraining improper conduct by senior management, the measures taken to enforce a formal code of conduct, and the effectiveness of the budgeting or responsibility reporting system. For a small, non-public company some of these matters might be considered inapplicable or unimportant, particularly if the auditor's past experience has been that effective owner-manager involvement creates an environment of good control consciousness.

11. The auditor should specifically assess the likelihood of management misrepresentation by reviewing information obtained about risk factors and the control environment. Matters such as the following may be considered:

- Are there known circumstances that may indicate a management predisposition to distort financial statements, such as frequent disputes about aggressive application of accounting principles that increase earnings, evasive responses to audit inquiries, or excessive emphasis on meeting quantified targets that must be achieved to receive a substantial portion of management compensation?
- Are there indications that management has failed to establish policies and procedures that provide reasonable assurance of reliable accounting estimates, such as personnel who develop estimates appearing to lack necessary knowledge and experience, supervisors of these personnel appearing careless or inexperienced, or there is a history of unreliable or unreasonable estimates?
- Are there conditions that indicate lack of control of activities, such as constant crisis conditions in operating or accounting areas, disorganized work areas, or frequent or excessive back orders, shortages, or delays?
- Are there indications of a lack of control over computer processing, such as a lack of controls over access to applications that initiate or control the movement of assets (for example, a demand deposit application in a bank), high levels of processing errors, or unusual delays in providing processing results and reports?
- Are there indications that management has not developed or communicated adequate policies and procedures for security of data or assets, such as employees in key positions not being investigated before hiring or who are not bonded or

[4] Some of these factors may also affect the risk of material error.

unauthorized personnel who have ready access to data or assets?

12. The auditor should consider the effect of the matters described in paragraphs 9 to 11 on the overall audit strategy and the expected conduct and scope of the examination and communicate his conclusions to other personnel involved in the audit.

13. *Responding to Risk at the Financial Statement Level.* The auditor's overall judgment about the level of risk in an engagement may affect engagement staffing, extent of supervision, overall strategy for expected conduct and scope of examination, and degree of professional skepticism applied. Thus, the auditor's assessment of risk may affect audit planning in one or more of the following ways. The experience and training of personnel assigned significant engagement responsibilities should be commensurate with the level of risk for the engagement. Ordinarily, higher risk requires more experienced personnel. Higher risk may also require more extensive supervision by the auditor with final responsibility for the engagement during both the planning and the conduct of the engagement. Higher risk may cause the auditor to expand the extent of procedures applied, apply procedures closer to or as of the balance sheet date, particularly in critical audit areas, or modify the nature of procedures to obtain more persuasive evidence. Higher risk will also ordinarily cause the auditor to exercise a heightened degree of professional skepticism in conducting the examination (see paragraphs 15 to 20).

14. *Considering Audit Risk at the Balance or Class Level.* At the account balance or class-of-transactions level, the auditor assesses inherent risk and control risk to develop an audit program to achieve audit objectives relevant to the balance or class. The following matters are examples of factors that may influence the auditor's judgment about risk at the balance or class level.

- Effect of risk factors identified at the financial statement or engagement level on the particular account balance or transaction class
- Complexity and contentiousness of accounting issues affecting balance or class
- Frequency or significance of difficult to audit transactions affecting balance or class
- Nature, cause, and amount of known and likely misstatements detected in the balance or class in the prior examination
- Susceptibility of related assets to misappropriation
- Competence and experience of personnel assigned to processing data that affects the balance or class
- Extent of judgment involved in determining the total balance or class
- Size and volume of individual items comprising the balance or class
- Complexity of calculations affecting the balance or class

Professional Skepticism and Management Misrepresentations

15. An examination of financial statements in accordance with generally accepted auditing standards should be planned and performed with an attitude of professional skepticism. The auditor neither assumes that management is dishonest nor assumes unquestioned honesty. Rather, the auditor recognizes that conditions observed and evidential matter obtained need to be objectively evaluated to conclude whether the financial statements are free of material misstatement.

16. Management integrity is important because management can direct subordinates to record transactions or conceal information in a manner that can materially misstate financial statements. When approaching difficult-to-substantiate assertions, the auditor should recognize the increased importance of consideration of factors that bear on management integrity. If all audits were conducted on the presumption of management dishonesty, however, the presumption would be contrary to the accumulated experience of auditors. Moreover, if dishonesty were presumed, the auditor would need to question the genuineness of all records and documents obtained from the client and would require conclusive rather than persuasive evidence to corroborate all management representations. An audit conducted on these terms would be unreasonably costly and impractical.

17. *Professional Skepticism in Audit Planning.* Whenever the auditor has reached a conclusion that there is significant risk of material misstatement of the financial statements, the auditor reacts in one or more ways. For example, the auditor may change the nature, timing or extent of procedures, assign more experienced staff, or require additional levels of supervision. The auditor may identify specific transactions involving senior management and confirm the details with reliable external parties and review in detail all material accounting entries prepared or approved by senior management.

18. The auditor should consider whether accounting policies are generally accepted and appropriate in the circumstances. However, when the auditor has reached a conclusion that there is significant risk of intentional distortion of financial statements, the auditor should recognize that management's selection and application of significant accounting policies, particularly those related to revenue recognition, asset realization, and capitalization versus expensing may be misused. Increased risk of intentional distortion of the financial statements should cause greater concern with whether accounting principles that are generally accepted are being used in inappropriate circumstances to create a distortion of earnings. For example, management might use the percentage-of-completion method in circumstances that do not justify its use to misstate operating results.

19. Large and unusual transactions, particularly at year-end, will

normally be selected for testing, and the auditor will insist on evidence sufficient to demonstrate that deferred costs are recoverable and that revenue has in fact been realized. When evaluation at the entity level indicates significant risk, the auditor requires either more or different evidence to support material transactions than would be the case in the absence of such risk. For example, the auditor may perform additional procedures to determine that sales are properly recorded, giving consideration to the possibility that the buyer has a right to return the product.

20. *Professional Skepticism in Performance of the Audit.* In performing procedures and gathering evidential matter, the auditor continually maintains an attitude of professional skepticism. The performance of auditing procedures during the examination may detect conditions or circumstances that should cause the auditor to consider whether material irregularities exist. If a condition or circumstance differs adversely from the auditor's expectation, the auditor needs to consider the reason for such differences. Examples of such conditions or circumstances follow:

- Analytical procedures disclose significant fluctuations that cannot be reasonably explained.
- Differences between reconciliations of a control account and subsidiary records or between an asset account and a general ledger account are not appropriately investigated and corrected on a timely basis.
- Confirmation requests disclose significant differences or yield fewer responses than expected.
- Transactions selected for testing are not supported by proper documentation or not appropriately authorized.
- Supporting records or files that should be readily available are not promptly produced when requested.
- Errors are detected in audit tests that apparently were known to client personnel, but were not voluntarily disclosed to the auditor.

When such conditions or circumstances exist, the planned scope of audit procedures should be reconsidered. As the number of differences from expectations or the ability to resolve them increases, the auditor should consider whether the assessment of the risk of material misstatement of the financial statements made at the planning stage is still appropriate. Also, the auditor should consider whether the conditions or circumstances indicate the likelihood of material irregularities and whether an increase in customary procedures will be adequate in the circumstances.

Evaluation of Audit Test Results

21. The auditor should evaluate the significance of differences between the accounting records and the underlying facts and circumstances established by the application of auditing procedures. The auditor should consider both the quantitative and qualitative aspects of these matters and whether they are indicative of an error or an irregularity. Often a particular matter considered in isolation cannot be identified as an error or irregularity—nevertheless, this evaluation is important. Because irregularities are intentional, they have implications beyond their direct monetary effect and the auditor needs to consider the implications for other aspects of the examination. If the auditor suspects that an audit difference is caused by an irregularity, he should consider the likely identity of the perpetrator, the method and pattern of concealment, the account balances and transaction classes affected, and, in light of these considerations, whether the financial statements could be materially affected.

22. The auditor's first concern is to reach a conclusion on whether the financial statements, taken as a whole, are materially misstated. The auditor should accumulate all audit differences during the examination and summarize and evaluate the combined effect at the conclusion of the examination. In this regard, the auditor may designate an amount as clearly negligible, below which audit differences need not be accumulated.

23. If the auditor has determined that an audit difference is, or may be, an irregularity, but has also determined that the effect on the financial statements could not be material, the auditor should—

a. Refer the matter to an appropriate level of management that is at least one level above those involved.

b. Be satisfied that, in view of the organizational position of the likely perpetrator, the irregularity has no implications for other aspects of the examination or that those implications have been adequately considered.

For example, irregularities involving misappropriation of cash from a small imprest fund would normally be of little significance because both the manner of operating the fund and its size would tend to establish a limit on the amount of loss and the custodianship of such a fund is normally entrusted to a relatively low-level employee.

24. If the auditor has determined that an audit difference is, or may be, an irregularity and has either determined that the effect could be material or has been unable to evaluate potential materiality, the auditor should—

a. Consider the implications for other aspects of the examination.

b. Discuss the matter and the approach to further investigation with an appropriate level of management that is at least one level above those involved.

c. Attempt to obtain sufficient competent evidential matter to determine whether in fact material irregularities exist and, if so, their effect.

d. If appropriate, suggest that the client consult with legal counsel on matters concerning questions of law.

If practicable, the auditor should extend his auditing procedures in an effort to obtain evidential matter to resolve any doubt about the existence of an irregularity.

THE EFFECT OF IRREGULARITIES ON THE AUDIT REPORT

25. If the auditor has concluded that the financial statements are materially affected by an irregularity, the auditor should insist that the financial statements be revised and, if they are not, express an adverse opinion on the financial statements taken as a whole disclosing all substantive reasons for his opinion.

26. If the auditor is precluded from applying necessary procedures, or if after the application of extended procedures, the auditor remains uncertain about whether possible irregularities may materially affect the financial statements, the auditor should—

a. Disclaim an opinion on the financial statements.

b. Indicate his findings in writing to the board of directors.

c. Withdraw from the engagement in appropriate circumstances.

Whether the auditor concludes that withdrawal from the engagement is appropriate depends on the diligence and cooperation of senior management and the board of directors in investigating the circumstances and taking appropriate remedial action. For example, if the auditor is precluded from obtaining reasonably available evidential matter, withdrawal ordinarily would be appropriate. Also, if a known perpetrator of an irregularity is retained in a position with a significant role in the control structure, withdrawal would ordinarily be appropriate. However, because of the variety of circumstances that may arise, it is not possible to describe all those circumstances when withdrawal would be appropriate.

COMMUNICATIONS CONCERNING ERRORS OR IRREGULARITIES

27. The auditor's responsibility to communicate audit adjustments within the entity whose financial statements are under examination is described in the proposed SAS, *Communications With Audit Committees or Others With Equivalent Authority and Responsibility*. The auditor should assure himself that the audit committee is adequately informed with respect to proposed adjustments arising from the audit, whether or not the adjustment is recorded by the entity. For this purpose, an audit adjustment is defined as a proposed correction of the financial statements detected as a result of applying audit procedures, that, in the auditor's judgment, may not have been detected otherwise.

28. In order for the audit committee to make the informed judgments necessary to fulfill its responsibility for the oversight of financial reporting, the auditor should assure himself that the audit committee is adequately informed with respect to any irregularities of which the auditor becomes aware during the examination unless those irregularities are clearly inconsequential. For example, a minor defalcation by an employee at a low level in the organization might be considered inconsequential. However, any irregularities involving senior management of which the auditor becomes aware should be reported directly to the audit committee.

29. Because of the importance of knowledge of irregularities to the audit committee's function, the audit committee should be informed whether or not the irregularities would have otherwise been detected. Irregularities that are individually immaterial may be reported to the audit committee on an aggregate basis, and the auditor may reach an understanding with the audit committee on the nature and amount of reportable irregularities.

30. Disclosure of irregularities to parties other than the client's senior management and its audit committee is not ordinarily part of the auditor's responsibility, and would be precluded by the auditor's ethical responsibility unless the matter affects his opinion on the financial statements. The auditor should recognize, however, that in the following circumstances a duty to notify parties outside the client may exist:

a. Disclosure to the SEC when the auditor has withdrawn or been dismissed and an auditor change is reported on form 8-K

b. Disclosure to a successor auditor when the successor makes inquiries in accordance with SAS No. 7, *Communications Between Predecessor and Successor Auditors* (AICPA, *Professional Standards*, vol. 1, AU sec. 315)

c. Disclosure to a court in response to a subpoena

d. Disclosure to a funding agency or other specified agency in accordance with governmental audit requirements

Responsibilities in Other Circumstances

31. This Statement describes the auditor's responsibilities to detect and report errors and irregularities in an examination of a complete set of financial statements made in accordance with generally accepted auditing standards. In other engagements, the auditor's responsibilities may be more extensive or more restricted depending on the terms of the engagement.

32. The auditor may accept an engagement that necessitates a more extensive responsibility to detect or report irregularities. In an examination in which governmental standards for audits of federally assisted programs apply, for example, the auditor should be aware that such standards go beyond generally accepted auditing standards as they relate to notification when the examination indicates that irregularities or illegal acts may exist. Governmental requirements for audits of federally assisted programs may call for the auditor not only to promptly report instances of irregularities to the audited entity's management, but also to report the matter to the funding agency or other specified agency.

33. When an examination does

not encompass a complete set of financial statements or a complete individual financial statement, or when the scope is less extensive than an examination in accordance with generally accepted auditing standards, the auditor's ability to detect material irregularities may be considerably reduced. For example, in an engagement to report on specified elements, accounts, or items of financial statements, the auditor's procedures focus on the specific element, account, or item and the special purpose of the engagement. In these circumstances, the auditor's assessment of risk at the financial statement level and in other aspects of the examination that relate to the entity and its financial statements taken as a whole is necessarily more restricted.

APPENDIX
CHARACTERISTICS OF ERRORS AND IRREGULARITIES

1. Characteristics of errors and irregularities that are relevant because of their potential influence on the auditor's ability to detect such matters are materiality of the effect on financial statements, level of management or employees involved, extent and skillfulness of any concealment, relationship to established specific control procedures, and the specific financial statements affected.

MATERIALITY

2. SAS No. 47, *Audit Risk and Materiality in Conducting an Audit*, paragraph 4, states that "financial statements are materially misstated when they contain errors or irregularities whose effect, individually or in the aggregate, is important enough to cause them not to be presented fairly in conformity with generally accepted accounting principles." SAS No. 47, paragraph 13, also states the following: "The auditor generally plans the audit primarily to detect errors that he believes could be large enough, individually or in the aggregate, to be quantitatively material to the financial statements." As used in SAS No. 47, the term "errors" refers to both errors and irregularities.

3. In planning the audit, the auditor is concerned with matters that could be material to the financial statements. An examination in accordance with generally accepted auditing standards may detect errors or irregularities that are not material to the financial statements, but such an examination can provide no assurance of detecting immaterial errors or irregularities. In this regard, there is no important distinction between errors and irregularities. There is a distinction, however, in the auditor's response to detected matters. Generally, an isolated, immaterial error in processing accounting data or applying accounting principles is not significant to the audit. In contrast, detection of an irregularity requires consideration of the implications for the integrity of management or employees and the possible effect on other aspects of the examination.

LEVEL OF INVOLVEMENT

4. An irregularity may be caused by an employee or by management and, if by management, by a relatively high or low level of management. The experience of auditors indicates that the level of involvement often combines with other characteristics in ways that have a predictable influence on ability to detect.

5. Defalcations by employees are often immaterial in amount and concealed in a manner that does not misstate net assets or net income. This type of irregularity can be more efficiently and effectively dealt with by a sound control structure and fidelity bonding of employees.

6. Material irregularities perpetrated by senior levels of management, including an owner-manager of a small business, are infrequent, but when they do occur they often engender widespread attention. These irregularities may not be susceptible to prevention or detection by specific control procedures because senior management is above the controls that deter employees or may override these controls with relative ease. Culture, custom, and the corporate governance system inhibit irregularities by senior management, but are not infallible deterrents. For this reason, an examination in accordance with generally accepted auditing standards necessarily gives due consideration to factors that bear on management integrity and the control environment.

CONCEALMENT

7. Concealment is any attempt by the perpetrator of an irregularity to reduce the likelihood of detection. Concealment usually involves manipulation of accounting records or supporting documents to disguise the fact that the accounting records are not in agreement with the underlying facts and circumstances. However, concealment can be skillful and elaborate or clumsy and limited. The auditor's ability to detect a concealed irregularity depends on the skillfulness of the perpetrator, the frequency and extent of manipulation, and the relative size of individual amounts manipulated.

8. Forgery may be used to create false signatures, other signs of authenticity, or entire documents. Collusion may result in falsified confirmations or other evidence of validity. Also, unrecorded transactions are normally more difficult to detect than concealment achieved by manipulation of recorded transactions. However, the effect of concealment on the ability to detect an irregularity is dependent on the particular circumstances. For example, an attempt to mislead users of financial statements by recording large, fictitious revenue transactions late in the period without supporting documentation would be more readily detected than fictitious revenue transactions spread throughout the period, individually immaterial in amount, and supported by legitimate-appearing invoices and shipping documents. Moreover, both of these irregularities might be extremely difficult, if not impossible, to detect if collusion of customers is added to the concealment scheme.

CONTROL STRUCTURE

9. If specific control procedures permit an error or irregularity to occur repeatedly and the repeated occurrence could accumulate to a material amount, the auditor's procedures should be planned to detect the error or irregularity. However, the auditor may not detect an error or irregularity that results from a nonrecurring breakdown of a specific control procedure because a rare item permitted by temporary conditions may not come to light in the performance of analytical or other procedures.

10. Irregularities may also be perpetrated or concealed by circumvention of specific control proce-

dures or may be perpetrated by a level of management above specific control procedures. These types of irregularities are generally more difficult for an auditor to detect. However, the auditor should consider whether there are circumstances or factors that indicate a higher risk of these types of irregularities and modify auditing procedures accordingly.

FINANCIAL STATEMENT EFFECT

11. Other matters remaining equal, errors or irregularities that involve overstatement will generally be more readily detected than those that involve understatement because the audit evidence available is more reliable for detecting such errors or irregularities. Also, if an error or irregularity involves misclassification or improper description within an individual financial statement, it will be more difficult to detect than one that affects both the balance sheet and the income statement. For example, a misappropriation of assets concealed by recording fictitious accounts receivable is more likely to be detected when the difference between recorded receivables and the actual amount owed by customers accumulates to a material amount, than if the same misappropriation were to be concealed by charging an expense account each period.

12. The foregoing discussion considers characteristics of errors and irregularities individually and explains the effect an individual characteristic tends to have on the auditor's detection ability. However, these characteristics may interact in particular circumstances in ways that also affect the auditor's ability to detect a specific error or irregularity.

EXPOSURE DRAFT

FILE 2545

PROPOSED STATEMENT ON AUDITING STANDARDS

THE AUDITOR'S RESPONSIBILITY TO DETECT AND REPORT ERRORS AND IRREGULARITIES

February 14, 1987
Comment date: July 15, 1987

Name and Affiliation:

Comments: ____

Instructions for Response Form

This perforated response form may be used for comments or suggestions relating to any aspect of the exposure draft that is of concern or interest to you. For convenience, the most significant points have been identified in the summary that accompanies this exposure draft.

TEAR ALONG DOTTED LINE

Comments (continued):